

**Testimony of Dr. Anthony B. Sanders**  
**Before the House of Representatives Subcommittee on Capital Markets, Insurance, and**  
**Government Sponsored Enterprises**  
**Topic: “Credit Default Swaps on Government Debt:**  
**Potential Implications of the Greek Debt Crisis”**

**April 29, 2010**

Mr. Chairman, and distinguished members of the Committee, my name is Dr. Anthony B. Sanders and I am the Distinguished Professor of Finance at George Mason University and a Senior Scholar at The Mercatus Center. It is an honor to testify before the House of Representatives Committee on Financial Services today.

**The Greek Debt Crisis**

On November 5, 2009, Reuters published a story entitled “Greek debt to reach 120.8% of GDP in '10.”<sup>1</sup> Everyone around the globe is aware of how Greece’s excessive debt fiasco could lead to a meltdown of the European economy at “only” 120% of GDP.<sup>2</sup> Things became even more critical when Greece discovered it had overlooked \$40 billion more – markets do not like surprises.

These stories about the Greek economy beg the following question: Was the cause of the Greek fiscal collapse perpetrated by credit default swaps (CDS) or was it the out of control spending and borrowing by the Greek government that led to Greece being, in popular parlance, “broke?”

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<sup>1</sup> <http://www.reuters.com/article/idUSATH00496420091105>

<sup>2</sup> On April 27, 2010, it was revealed that S&P has cut the ratings for both Greece and Portugal. Spain is also in deep trouble. <http://www.marketwatch.com/story/us-stocks-tumble-after-sp-cuts-greece-portugal-djia-off-128-2010-04-27>

## Credit Default Swaps (CDS)

The most common type of credit derivative is the credit default swap (CDS). A CDS is simply an exchange of a fee in exchange for a payment if a “credit default event” occurs. With a CDS, the Investor does not take price risk of the Reference Asset (such as Greek government debt), only the risk of default. The Investor receives a fee from the Seller of the default risk. The Investor makes no payment unless a credit default event occurs.<sup>3</sup> CDS are traded in basis points (100 basis points equal 1% in interest rates). As the risk of default increases, the credit rating will decrease which raises the price for protection and widening the basis point spread at which a CDS is trading.

Credit default swaps (CDS) play two important roles in the market for credit. First, they facilitate liquidity by allowing investors to hedge against negative outcomes (e.g., defaults) and second, CDS provide vital information to other market participants about the risk of a particular investment. This price (or spread) conveys information to potential investors, communicating the level of risk involved in an investment, and helping them to make a more informed and prudent investment decision. Restricting either of these roles risks making credit less widely available and markets less transparent.

Credit default swaps (CDS) are the current “villain de jour” in the Greek debt fiasco. The Greek crisis is the result of massive government spending and debt issuance to fund the

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<sup>3</sup> See, for example, <http://www.tavakolistructuredfinance.com/CDS.pdf>

spending. In fact, CDS on Greek sovereign debt actually served a positive role: it alerted everyone around the globe that Greece was in a credit death spiral.<sup>4</sup>

CDS is often misunderstood. Essentially, CDS allows investors to hedge their positions in debt (in this case, default of Greece's sovereign debt). An investor may hold Greek sovereign debt (long) and may want to fully or partially insure against default on the debt.<sup>5</sup>

By limiting or abolishing CDS, you not only decrease liquidity for investors (which we know is a terrible idea), but you actually decrease liquidity in the underlying asset, in this case Greek sovereign debt.<sup>6</sup> To state it differently, how many investors are willing to go long on Greek debt if they were forbidden or curtailed from purchasing protection on the downside?

As can be seen in Exhibit 1, the CDS spreads started to increase in October and November, 2009. By December 2009, CDS spreads widened dramatically. Of course, the spreads widen even more in January and February signaling the seriousness of the Greek credit crisis. As Peter Wallison has pointed out, "A widening of a reference entity's CD spread will alert investors that they should investigate risk-taking more fully before advancing funds."<sup>7</sup> So, CDS

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<sup>4</sup> It is not necessarily the sudden inability to make payments on outstanding debt that causes default, but the inability to fund maturing debt with new debt. The issue instead is whether new debt can be sold at all and at what interest rate on the rollover date which could send interest costs upwards.

<sup>5</sup> As a rule, fixed income investors are not speculators. What they are trained to do is evaluate risk, demand a risk-based return and a return of principal. What they have difficulty doing is evaluating unknowns, such as what will Greece likely look like over the entire length of the holding period. The greater the degree of uncertainty, the greater the return they will demand. Rather than demanding that Greece pay higher interest rates, those who were most concerned can purchase insurance against this uncertainty with CDS just like anyone else who buys insurance is limiting their risk. Since the alternative was higher interest rates, CDS actually saved Greece money over the years.

<sup>6</sup> Rene Stulz has argued that eliminating over-the-counter trading of credit default swaps could reduce social welfare and were not responsible for the recent financial meltdown in the US. See [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1475323](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1475323)

<sup>7</sup> Peter Wallison, "Everything You Wanted to Know about Credit Default Swaps—but Were Never Told," American Enterprise Institute, December 2008.

actually serve a public purpose by providing credible information about evolving risk in sovereign debt markets.

Consider further “The Greek Surprise!” when on April 2, 2010, a story in the press revealed that “Greece "Discovers" \$40 Billion of Previously Unknown Debt, CDS Widens.” For a country that is already in deep trouble in terms of making its debt payments, the discovery of another \$40 billion of debt came as a rude surprise to those that invested in Greek debt. Notice in Exhibit 1 how Greek CDS spiked around the time of the revelation of \$40 billion in undiscovered debt. Markets reacted swiftly to the news, which indicates 1) the value of having CDS as a credit monitoring device and 2) the importance of fully disclosing the debt that a country is obligated to pay.

There have been recommendations that CDS be abolished, regulated or controlled. Regulation should set good standards against fraud and deceptive behavior, but should avoid tinkering with particulars because, as Ian Malcolm said in Jurassic Park, “Life will find a way.” The same thing is true for risk management and investing. Financial markets evolve independently and are often hindered rather than helped by regulation. Alan Greenspan has stated in U.S. Senate testimony that “The market will continue to force change whether or not Congress Act. .... Without Congressional action changes will occur through exploitation of loopholes and marginal interpretations of the law that the courts fee obliged to sanction. The type of response to market forces leads to inefficiencies ...”<sup>8</sup> As we know, it would be fairly easy

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<sup>8</sup> Statement by Alan Greenspan, Chairman Board of Governors of the Federal Reserve System before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, June 17, 1998, in reference to H.R. 10, Financial Modernization, page 1.

to create a new security or instrument that would be one or steps ahead of the regulators, but provide the hedging that investors demand.

Focusing on the instrument as the cause of a problem, in this case CDS, misses the real culprit: the behavior of the underlying asset. With Greece, CDS reacted to the behavior of the underlying asset - Greek sovereign debt. Just as in the housing crisis, CDS have been blamed for exacerbating the crisis but really it was the behavior of the underlying asset – mortgages – that was at issue. If you're looking to place blame, don't blame the instrument; blame the behavior of the underlying asset. Greece hid its debt. Markets found out and reacted appropriately. This is a lesson that we would do well to learn in the U.S.

### **Fannie Mae, LBJ and Hiding the Debt from the Public**

Our own sovereign debt has a “Greek surprise” component to it. It's called the GSE and Agency debt.<sup>9</sup> As Secretary Geithner tried to emphasize in a recent House hearing, the Federal government's support to Fannie and Freddie, "does not change the legal status." In addition, he stated that "The corporate debt of the GSEs is not the same as U.S. Treasuries, nor should it be considered sovereign debt."<sup>10</sup>

Secretary Geithner went on to say that he wanted to eliminate the “ambiguity” over the government's involvement in mortgage finance companies Fannie Mae and Freddie Mac. I agree completely with Secretary Geithner on this score. But to end the ambiguity, it is

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<sup>9</sup> There are other off-balance sheet liabilities as well in the Federal government such as the Pension Benefit Guaranty Corporation that only appears on the Federal budget when there is a loss.

<sup>10</sup> March 23, 2010 hearing of the U.S. House Financial Services Committee.

important to revisit why Fannie and Freddie are not considered to be sovereign debt by Secretary Geithner.<sup>11</sup>

In 1968, President Lyndon Johnson had difficulty fighting a war, delivering his Great Society programs and financing mortgages on the government's balance sheet. So, it was decided that Fannie Mae would move off budget, reducing federal borrowing rather than making the tough budgetary decisions. In part, it was a reaction to the attempt to raise the Federal debt limit and the stiff resistance that faced the Administration. If removing Fannie Mae from the Federal balance sheet was intended to create "shadow debt" that had no Federal guarantee, it makes sense that moving it back on balance sheet actually recognizes what most have guessed at over the years: the Federal government will support Fannie and Freddie in times of distress.

While it may have been a clever budgetary trick or debt ceiling avoidance tactic in 1968, it blew into a serious problem by September 7, 2008 when the Bush Administration placed Fannie and Freddie into conservatorship. On Christmas Eve 2009, the credit markets were taken by surprise by an announcement from Treasury that the \$200 billion caps on Fannie and Freddie for capital infusions were lifted and the Federal government would cover all losses at Fannie and Freddie.

In short, if it looks like a guarantee, sounds like a guarantee and acts like a guarantee, it is a guarantee. And the Federal government needs to end the ambiguity and put Fannie and Freddie back on the Federal balance sheet where they belong.

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<sup>11</sup> In fairness to Fannie and Freddie, much of their debt and guarantee are backed by cash flows, so only a percentage of their \$8 trillion in debt and guarantees will have to be covered by taxpayers. However, GSE debt and guarantees are de-facto liabilities for the American taxpayer and should be considered as such. In addition, there are other Among the other costly programs such as Pension Benefit Guaranty Corporation, federal employee pensions, and Federal Home Loan Bank debt.

To highlight why this is important, I have prepared Exhibits 2 and 3 that illustrate the situation. In Exhibit 2, it is clearly shown that on-balance Federal Debt is above \$8 trillion. The problem is our off-balance sheet GSE debt and guarantees are also around \$8 trillion. So, President Johnson's budgetary trick has resulted in a shadow debt that is comparable to our on-balance sheet debt.

### **Further Budgetary Complications**

Veronique de Rugy at George Mason University and The Mercatus Center has pointed out that through 2040, spending on Medicare and Medicaid is projected to grow to 11% of GDP from its current 5%. In terms of interest costs to maintain our debt, interest costs are projected to increase by more than 7 times by 2040 to 9.3% of GDP which is a far larger share of our GDP than is currently dedicated to any single department, war or program.<sup>12</sup> Unfunded liabilities (those for which we need to raise taxes or borrow to fund) currently amount to \$108.4 trillion - that figure is almost 7 times higher than our current Federal debt (with GSEs and Agencies added in). These unfunded liabilities amount to \$351,000 per citizen.<sup>13</sup> This further raises the flag that we need, as a country, to acknowledge what we owe today so we can better manage our finances in the future.

Thank you for allowing me to share my thoughts with you today.

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<sup>12</sup> <http://mercatus.org/publication/net-interest-rivals-general-spending-2040>

<sup>13</sup>As of 2009, households earning \$250,000 or more accounted for approximately 2% of all households. If we multiply the number of households (115,000,000) by 2%, we find that 2,300,000 households will bear the brunt of the \$108 trillion of underfunded liabilities. This means that households earning \$250,000 or more are each responsible for \$47 million to pay for these unfunded liabilities.

Exhibit 1. Greece CDS Rates

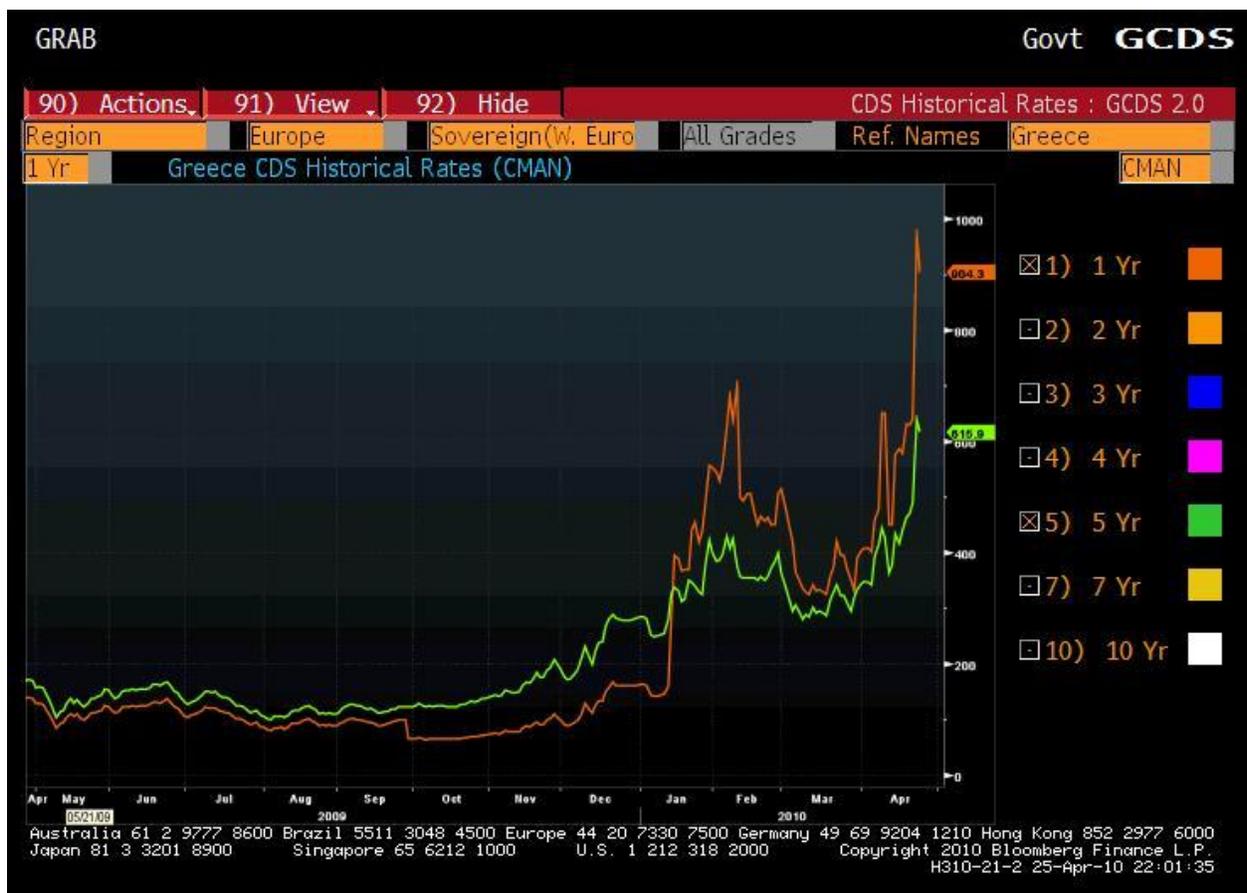


Figure 2.

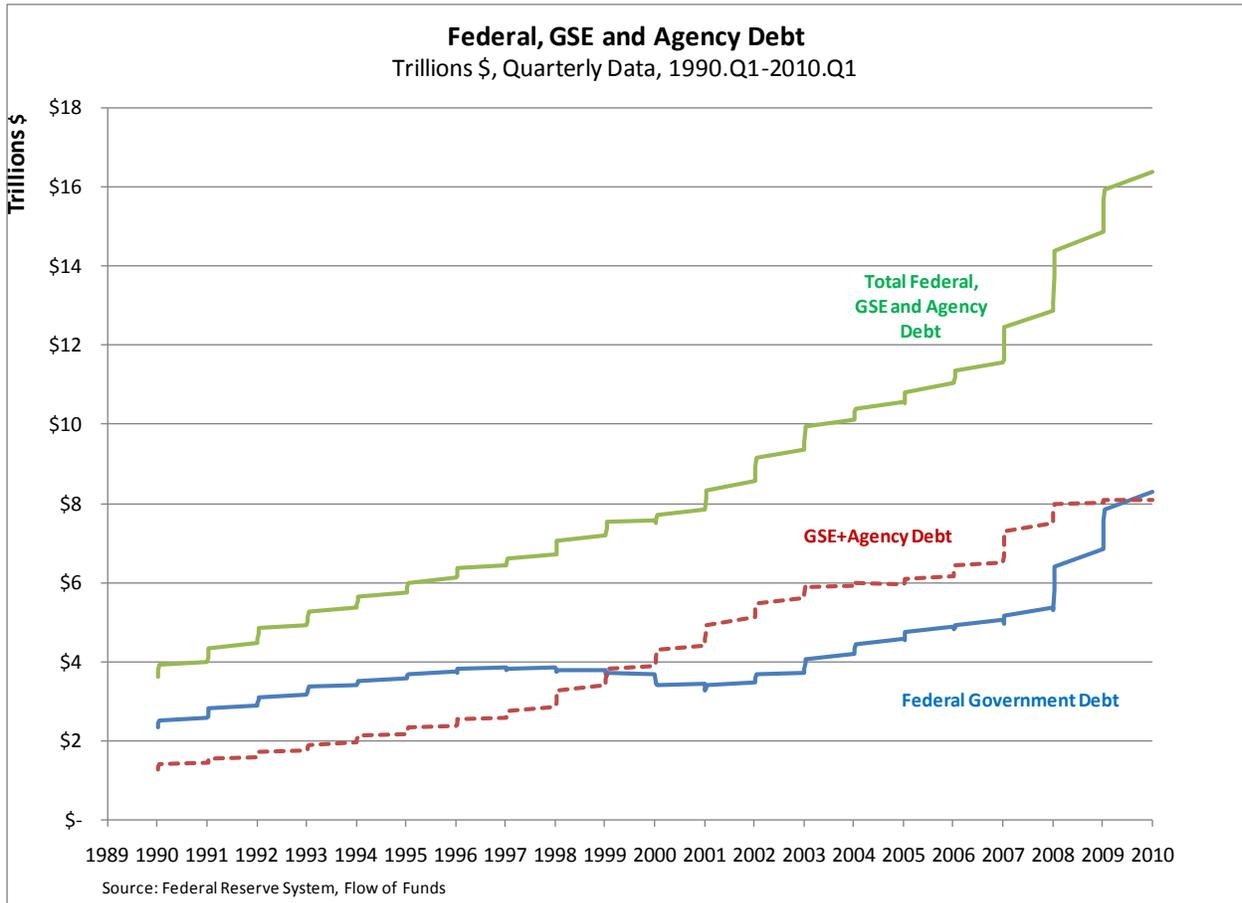
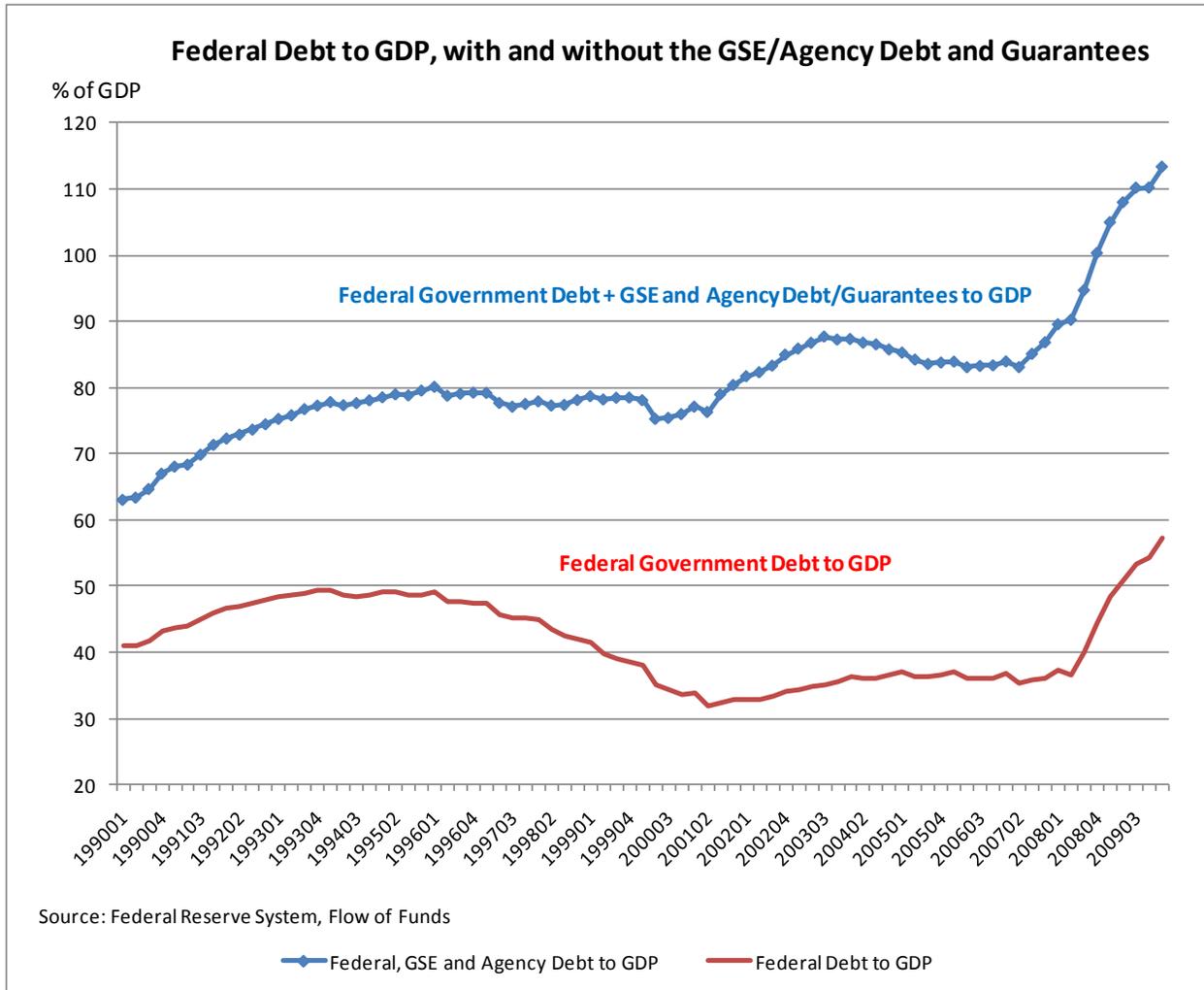


Figure 3.



## Biography

Anthony B. Sanders is Professor of Finance in the School of Management at George Mason University where he is the Distinguished Professor of Real Estate Finance. He is a Senior Scholar with The Mercatus Center. He has previously taught at University of Chicago (Graduate School of Business), University of Texas at Austin (McCombs School of Business) and The Ohio State University (Fisher College of Business). In addition, he served as Director and Head of Asset-backed and Mortgage-backed Securities Research at Deutsche Bank in New York City. He is the coauthor of "Securitization: Structuring and Investment Analysis" (Wiley Finance) with Andrew Davidson.

His research and teaching focuses on financial institutions and capital markets with particular emphasis on real estate finance and investment. He has published articles in *Journal of Finance*, *Journal of Financial and Quantitative Analysis*, *Journal of Business*, *Journal of Financial Services Research*, *Journal of Housing Economics* and other journals. He has given presentations to the European Central Bank in Frankfurt, Exane BNP Paribas in Paris and Geneva and the Bank of Japan. He has given presentations in Chile, Japan, China, Poland, United Kingdom and Mexico in recent years as well.

<http://mason.gmu.edu/~asander7/>